



19 May 2009

Dr Ron Ben-David
Chairperson
Essential Services Commission
Level 2
35 Spring Street
MELBOURNE VIC 3000

Dear Ron

Metropolitan Melbourne Water Price Review 2009 – Response to Draft Decision

We welcome the Commission's Draft Decision on our Water Plan. This letter provides an overview of our response to the Draft Decision, while the accompanying document sets out further details.

Yarra Valley Water's Water Plan reflects the challenges resulting from the present drought and climate change. Accordingly, it provides for the significant investment that is required to secure new water supplies in order to ease the present water restrictions. Our focus in preparing our Water Plan and in responding to the Draft Decision is to ensure customers' service levels are maintained, and to keep water bills as low as possible for the regulatory period. In accordance with the Government's commitment, we are aiming to ensure that water bills no more than double over the five years to 2012/13.

Efficiency

It is important to note that Yarra Valley Water's 2007/08 operating expenditure was incurred against a backdrop of strong internal restraints on spending (given the impact of the drought on our total revenues), and within the price cap administered by the Commission. Within this financial and regulatory environment, we faced very strong incentives to minimise our 2007/08 operating expenditure. The strong pressures for cost containment and rigorous cost management have continued into 2008/09.

Yarra Valley Water has the lowest operating cost per property in Melbourne and has managed its costs to ensure it remains at the forefront of efficiency. This is confirmed by the consultants to the Victorian Competition and Efficiency Commission review who stated: *"...in real terms, there has been virtually no increase in operating costs over the period 1995/96 to 2006/07 for CWW and SEW. YVW costs, in real terms, have decreased over the same period."*¹ At a

¹ Pricewaterhouse Coopers, 2007, *Victorian Competition and Efficiency Commission, Financial analysis of Melbourne's water retailers: Final Report*, November, p 14

national level, Yarra Valley Water is also amongst the water utilities with the lowest per property cost. We are committed through our Water Plan to remain at the forefront of efficiency.

We note the Commission's Draft Decision implies a controllable operating cost efficiency of 1.5 per cent per annum over the regulatory period. This comprises the 1 per cent per annum efficiency gain we proposed in our Water Plan, the \$7 million in shared services operating cost efficiencies over the regulatory period and absorption of minor increases in operating costs. We believe that, consistent with the reasoning of the Victorian Competition and Efficiency Commission, the shared services savings will take longer to achieve than currently anticipated by the Commission.

Operating cost benchmarks

The Draft Decision proposes the adoption of a controllable operating expenditure allowance for Yarra Valley Water that is, in aggregate, \$22.6 million below the allowance proposed by us for the four years from 2009/10 to 2012/13, as shown in table 1.

Table 1: Yarra Valley Water's controllable operating expenditure (\$ million, January 2009)

	2009/10	2010/11	2011/12	2012/13	Total
YVW proposal	110.8	112.7	113.9	114.3	451.7
Draft Decision	108.2	106.5	107.5	106.9	429.1
Draft Decision Proposed Reduction	2.6	6.2	6.4	7.4	22.6

It is worth noting the following comment from the Commission (page 41 of the Draft Decision):

"All three retailers have proposed a significant increase in controllable operating expenditure from 2007-08 to 2012-13. City West Water's operating expenditure is forecast to increase by 21 per cent (from \$72 million to \$88 million), South East Water's by 16 per cent (from \$110 million to \$128 million), and Yarra Valley Water's by 10 per cent (from \$104 million to \$114 million)."

We proposed the lowest percentage increase of the three retailers. While the Draft Decision proposes reductions in the operating expenditure allowances sought by all of the water utilities, the increase in total controllable operating expenditure allowed for Yarra Valley Water over the forthcoming regulatory period is modest in comparison to those proposed for the other water utilities.

Due to our size, proximity to water catchments and our prevailing geology (whereby conditions have impacted infrastructure), we experience the same volume of infrastructure maintenance incidents (such as sewer blockages, leaks and bursts) as City West Water and South East Water combined. Despite these unfavourable conditions, we will remain at the forefront of operating efficiency.

As noted in further detail in the accompanying submission, we consider that there are specific areas in which some increases in the proposed operating expenditure allowance are required in order to ensure that the allowance conforms with the Regulatory Principles set out in clause 14(1)(a) of the Water Industry Regulatory Order (WIRO), namely that the prices approved by the Commission:

- (i) provide for a sustainable revenue stream to Yarra Valley Water that nonetheless does not reflect monopoly rents and or inefficient expenditure by the Company; and
- (ii) allow Yarra Valley Water to recover its operational, maintenance and administrative costs.

Demand

Our principal concern about the demand forecasts in the Draft Decision relates to 2009/10. The Commission has increased our demand forecast from 150 litres per person per day to 155 litres per person per day while the Target 155 program is in place. The Target 155 program has been operating since December 2008 and is gaining momentum.

Based on the response of Yarra Valley Water's customers to date, we project annual residential water use in Yarra Valley Water's service area of 150 litres per person per day in 2009/10. Further details are provided in the attached response.

Prices

In its Draft Decision, the Commission stated that it was not satisfied with our Water Plan proposal to have uniform price increases that limit additional bill impacts for customers at a time of high price rises. The Commission suggested that this approach would mean that prices do not adequately reflect costs and would therefore not send the correct signals to customers.

We agree with the Commission's view that customers should receive a price signal that conveys the cost of Melbourne's new water supplies in water charges. We are proposing to apply the price increase in accordance with the Commission's requirements by applying our Water Plan price path to water usage charges and reduce the increases in the sewage disposal charge and water and sewerage service charges.

Further details of our response to the Draft Decision are provided in the Attachment.

If you require further details please contact Brett Mathieson, Acting General Manager Strategy and Communications on 9872 2441.

Yours sincerely



Pat McCafferty
A/Chief Executive Officer



Yarra Valley Water | a fresh approach

Metropolitan Melbourne Water Price Review 2009 - Response to Draft Decision

Yarra Valley Water - May 2009



Contents

Key outcomes and service levels.....	3
Operating expenditure.....	5
Capital expenditure	29
Financing capital investments - WACC	30
Financing capital investments – other matters	36
Demand forecasts	37
Bulk water and sewerage.....	42
Retail water and sewerage services	43
Recycled water.....	45
Trade waste.....	47
Other services	48

Key outcomes and service levels

Core service standards

We welcome the Commission's proposal to approve our core service standards, with the targets for the regulatory period to be based on the average of the three-year period from 2005/06 to 2007/08.

Additional service standards

We note that the Commission is proposing to approve most of our additional proposed service standards and targets. We also note the Commission's request for the inclusion of two additional service standards and a change to the water conservation standard. We are agreeable to the inclusion of the two additional standards.

The targets for the regulatory period for these two additional standards are set out in Table 1.

Table 1: Additional service standards and targets for regulatory period

Service standard	Average 2005/06 to 2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Compliance with EPA's discharge monitoring programs for YVW's sewage treatment plants (per cent)	99.98%	100%	100%	100%	100%	100%
Compliance with <i>Safe Drinking Water Act</i> 2003 obligations (per cent)	100%	100%	100%	100%	100%	100%

In relation to the change proposed by the Commission to our water conservation service standard, we believe that the existing standard is appropriate, and it is a key measure of the success of our water conservation program. We do not support the introduction of the Commission's suggested service standard for residential water consumption. Though worthwhile, it focuses on only one segment of our water conservation program. Our total water use measure, on the other hand, encompasses residential use, business use and non revenue water.

Our proposed water conservation indicator:

- continues from the first regulatory period

- is consistent with the key Central Region Sustainable Water Strategy (October 2006) target of reducing total water use in Melbourne from 331 litres per person per day to 317 litres per person per day by 2015 and 296 litres per person per day by 2020¹
- is consistent with the State Water Plan (June 2007) which states: “*we will continue to develop our approach to water conservation and household and industrial use of water, building on the excellent effort of Victorians to conserve water*”²
- provides a measure of how well we are targeting our program to save water at the lowest cost from all available water
- has not been proposed by other water utilities.

Guaranteed service levels (GSLs)

We welcome the Commission's intention to approve our Guaranteed Service Levels events and the doubling of payments.

The Commission has required that:

“the three retail businesses to develop an appropriate GSL event related to compliance with their hardship policies and programs, propose a payment amount for the event and propose monitoring and reporting measures for the event.” (Page 33 of the Draft Decision)

We note that the Commission has suggested that the new hardship-related GSL should be along the lines of:

“Restricting the water supply of, or taking legal action against, a customer in hardship who is complying with an agreed payment plan.” (Page 31 of the Draft Decision)

We agree that an additional hardship-related GSL is worthwhile and the Commission's suggestion is appropriate with a payment of \$50 per event. We do not expect Yarra Valley Water will need to make any payments in relation to this GSL.

¹ Victorian Government Department of Sustainability and Environment, 2006, *Sustainable Water Strategy Central Region, Action to 2055*, October, p 91

² Victorian Government Department of Sustainability and Environment, 2007, *Our Water Our future: The Next Stage of the Government's Water Plan*, June, p 5

Operating expenditure

Introduction

Operating costs are an important component of the buildings blocks which determine our revenue requirement. We support many of the Commission's decisions on operating costs but we have some concerns in relation to some aspects of the Commission's Draft Decision.

The Draft Decision proposes the adoption of a controllable operating expenditure allowance for Yarra Valley Water that is, in aggregate, \$22.6 million below the allowance we proposed for the four years from 2009/10 to 2012/13. Table 2 compares the allowance proposed by Yarra Valley Water and that adopted by the Commission in its Draft Decision.

Table 2: Yarra Valley Water's controllable operating expenditure (\$ million January 2009)

	2009/10	2010/11	2011/12	2012/13	Total
YVW proposal	110.8	112.7	113.9	114.3	451.7
Draft Decision	108.2	106.5	107.5	106.9	429.1
Draft Decision Proposed Reduction	2.6	6.2	6.4	7.4	22.6

The reduction proposed in the Draft Decision is substantial.

This section of our response details the areas in which we consider that the Draft Decision provides insufficient operating expenditure to enable the delivery of the services and other outcomes proposed in our Water Plan. Table 3 summarises our increased operating expenditure proposals.

Table 3: Yarra Valley Water's proposed increases in controllable operating expenditure over the Draft Determination (\$ million January 2009)

Area	2009/10	2010/11	2011/12	2012/13	Total
Water conservation (Target 155 program)	1.19	0	0	0	1.19
Greenhouse gas	0.45	0.47	0.49	0.51	1.92
Billing and collection	0.80	1.12	1.28	1.43	4.63
Information Technology (IT)	1.10	1.05	1.05	1.05	4.25
Allocation of costs and revenues between prescribed and non-prescribed services	1.42	1.30	1.18	1.07	4.97
Minor items (trade waste reform)	0.17	1.02	0.28	0.21	1.68
Productivity gains (shared services)	0.50	1.00	0.50	0	2.00

Area	2009/10	2010/11	2011/12	2012/13	Total
Total adjustments in operating expenditure proposed	5.63	5.96	4.78	4.27	20.64
Adjustment in uncollected revenue	0.85	1.28	1.42	1.54	5.09

Before turning to these specific matters in more detail, it is worth noting the following observation (page 41 of the Draft Decision):

“All three retailers have proposed a significant increase in controllable operating expenditure from 2007-08 to 2012-13. City West Water’s operating expenditure is forecast to increase by 21 per cent (from \$72 million to \$88 million), South East Water’s by 16 per cent (from \$110 million to \$128 million), and Yarra Valley Water’s by 10 per cent (from \$104 million to \$114 million).”

We proposed the lowest percentage increase of the three retailers. While the Draft Decision proposes reductions in the operating expenditure allowances sought by all of the metropolitan retail water utilities, the increase in total controllable operating expenditure allowed for Yarra Valley Water over the forthcoming regulatory period is modest in comparison to those proposed by the Commission for the other businesses.

Due to our size, proximity to water catchments and our prevailing geology (whereby conditions have impacted infrastructure), we experience the same volume of infrastructure maintenance incidents (such as sewer blockages, leaks and bursts) as City West Water and South East Water combined. The associated costs represent the single largest element of our controllable operating expenditure.

The increase in Yarra Valley Water’s operating expenditure is not only the lowest in percentage terms; it is also being applied to a comparatively low base given the scale of our operations. Based on this, we believe the Draft Decision’s proposed controllable operating expenditure allowance should be reviewed.

As noted in further detail in this submission, we consider that there are specific areas in which some increases in the proposed expenditure allowance are required in order to ensure that the allowance conforms with the Regulatory Principles set out in clause 14(1)(a) of the Water Industry Regulatory Order (WIRO), namely that the prices approved by the ESC:

- (i) provide for a sustainable revenue stream to Yarra Valley Water that nonetheless does not reflect monopoly rents and or inefficient expenditure by the Company; and
- (ii) allow Yarra Valley Water to recover its operational, maintenance and administrative costs.

The remainder of this section of the submission sets out our detailed responses on the areas of operating expenditure in which adjustments to the Draft Decision’s proposals are required.

Water supply and demand balance and conservation programs

We note the Commission has accepted the recommendations of the expenditure consultants in relation to our additional proposed expenditure on our water conservation program – refer table 4. We accept the Commission’s conclusion in relation to reductions to our water conservation expenditure in 2011/12 and 2012/13.

Table 4: Adjustments to water conservation expenditure forecasts proposed in Draft Decision (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Water conservation	2.09	0	-0.23	-0.46	1.40

We are concerned with the Commission's Draft Decision to disallow the additional expenditure on the Target 155 (T155) program in 2009/10, for the reasons outlined below.

A key change to our Water Plan expenditure profile was the inclusion of expenditure on the T155 program following its introduction in December 2008. The Government's T155 is a response to the poor storage filling season over the winter and spring of 2008. It is a voluntary campaign in addition to Stage 3a restrictions, designed to achieve water savings equivalent to Stage 4. At the same time, it provides flexibility for residential and non-residential customers. The success of T155 depends, in part, on water retailers being able to provide customers with appropriate assistance and water conservation solutions. It should be noted that because of the extended drought and extremely low storage levels, T155 programs are designed to encourage additional water savings beyond those required to meet the minimum targets associated with the Central Region Sustainable Water Strategy.

The T155 program is forecast to continue until end 2009/10. We sought additional amounts in relation to the cost of the program of \$2.19 million in 2008/09 and \$3.28 million in 2009/10 – refer table 5. The expenditure consultants recommended an amount of \$2.09 million in 2009/10 on the grounds that, on a per customer basis, *"it does not seem reasonable to expect that the cost of this program will increase significantly after the first year when there are initial set-up costs"*³ and this amount was accepted in the Commission's Draft Decision.

We note that the other retailers have included elements of our T155 program, such as water conservation kiosks in shopping centres and washing machine program, in their base water conservation programs. Therefore comparing the relative costs of each water utilities' T155 program in the absence of considering the scope of their particular T155 programs and their broader total water conservation programs can lead to invalid conclusions, which we believe has occurred on this occasion.

Table 5: Additional water conservation expenditure required for Target 155 program (\$ million January 2009)

Element	2008/09	2009/10	2010/11	2011/12	2012/13
ESC Draft Decision	2.19	2.09	0	0	0
Target 155 program – YVW proposal	2.19	3.28	0	0	0
Proposed YVW increase over Draft Decision	0	1.19	0	0	0

³ Halcrow Pacific P/I and Deloitte Touche Tohmatsu, 2009, Essential Services Commission: Yarra Valley Water Expenditure Review: Final Report, March, p 70

Our T155 program in 2009/10 is planned to comprise the following elements:

- Water conservation kiosks in shopping complexes offering water conservation advice and a channel for the accelerated take up of water conservation kits and associated behaviours (costing \$0.780 million per annum).
- Toilet retrofit program, offering customers a one-stop shop for the replacement of inefficient toilets at a subsidized cost (\$0.600 million per annum) - this cost reflects our share of a proposed program to changeover up to 25,000 inefficient toilets across Melbourne.
- Efficient clothes washer program offering assistance and targeted rebates (\$0.305 million per annum) - this cost reflects our share of a pilot program of 5000 extra efficient clothes washers across Melbourne to further accelerate take up given the extreme drought.
- High residential users behaviour change program (\$0.312 million per annum) – this cost reflects our costs in engaging very high users.
- Contact Centre support for higher incidence of calls associated with T155 (\$0.070 million per annum).
- Support T155 program – a program encouraging the business sector to implement additional savings via audits and retrofits in response to extreme drought (\$0.150 million per annum).
- Communication and mass media programs for T155 (\$1.063 million per annum).

By comparison, expenditure for T155 in 2008/09 is forecast at \$2.19M for items similar to those listed above but excluding the toilet retrofit program, the pilot efficient clothes washer program and a full scale high residential users program.

We consider that the Commission's consultants have erroneously formed a view that the T155 program is primarily focussed around communication and mass media campaigns. This misconception appears to have led the consultants to conclude that *"it seems reasonable for a business to be spending approximately \$1.0 million in 2009/10 on Target 155 plus an allowance for in-house costs."*⁴ As indicated above, our T155 program covers a number of other elements that focus on achieving water savings from particular customer segments, and that efforts in relation to this aspect are planned to increase in 2009/10.

The expenditure consultants also concluded:

"Yarra Valley Water is proposing a cost of \$5.49 per customer in 2009/10. This is at the high end of the range of costs proposed by the retailers for this program. It does not seem reasonable to expect that the costs of this program will increase significantly after the first year when there are initial set up costs.

We therefore recommend that Yarra Valley Water's proposed expenditure be increased by only \$2.09 million for 2009/10 for the target 155 program so that its expenditure per customer is equal to South East Water's proposed expenditure per customer (average across 2008/09 and 2009/10 of \$3.50)."

⁴ Ibid, p 70

The basis for this comparison should be examined in detail, as we note other retailers have defined their core water conservation expenditure to include elements of expenditure that we have classified as being part of our T155 program. If the T155 campaign expenditure is summed with approved water conservation expenditure, Yarra Valley Water will have the lowest cost per customer by a significant margin.

We believe that our proposed T155 expenditure for 2009/10 is prudent and efficient and it should be accepted by the Commission and incorporated into the overall allowance for our water conservation operating expenditure.

Electricity and greenhouse gas expenditure

Electricity

We welcome the Commission's acceptance of our expenditure proposals for the 2009/10 and 2010/11 years in relation to our electricity expenditure forecasts, and we note the reduced expenditure for 2011/12 and 2012/13 provided in the Draft Decision – refer table 6.

Table 6: Adjustments to electricity expenditure forecasts proposed in Draft Decision (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Electricity	0	0	-1.00	-1.12	-2.12

We accept the reduction for 2011/12 and 2012/13 given the uncertain nature of forecast energy costs, particularly with the introduction of the Australian Government's carbon pollution reduction scheme on 1 July 2010. We note that the expenditure consultants have indicated that *"the ESC will consider a pass-through for the impact of the scheme"*⁵ Our acceptance of the expenditure reductions in 2011/12 and 2012/13 is subject to the Commission allowing a pass through of additional costs associated with the Australian Government's carbon reduction scheme, should any such additional costs arise.

Greenhouse gas

For the first regulatory period, we adopted a target of offsetting 50% of our greenhouse gas emissions. This was accepted by the Commission in its final decision. Since 2007, we have achieved zero net greenhouse gas emissions from our operations by assigning benefits generated through our showerhead exchange program.

In our Water Plan, we set out our aim of achieving zero net greenhouse gas emissions for the period. Our 2006 customer willingness to pay research showed that 76% of our customers supported this aim. We identified that we would offset 28,107 tonnes of CO₂ in 2009/10 rising to 31,616 tonnes in 2012/13 through credits gained from our showerhead program. It was our intention to participate in the VEET scheme to receive accredited certificates.

⁵ Ibid, p 49

We now understand that showerheads exchanged with the customer (and to be installed by the customer) may not qualify for credits under the VEET scheme. Advice from the Commission to date is that to qualify for credits under the VEET scheme, we will need to gain accreditation and each showerhead will have to be installed by Yarra Valley Water or its agent rather than the customer.

On the basis of this advice, achieving our objective through the VEET scheme would incur additional costs. We estimate that the additional cost is between \$60 and \$90 per showerhead over the cost of our current scheme where the customer self-installs. Even offsetting the cost with the value of the certificates at the top of the possible range of price of certificates (around \$40) there will be a shortfall of between \$20 and \$50 per showerhead.

The current value of certificates is between \$12 and \$20 per tonne of CO₂. It will be more efficient to purchase certificates to meet our zero emissions objective than to change our showerhead exchange process. We estimate that taking a mid-point value for certificates of \$16 we will require the additional expenditure allowance shown in table 7. This additional allowance should be included in Yarra Valley Water's operating expenditure forecast for the purpose of the Commission's Final Decision.

Table 7: Additional costs of greenhouse gas offsets (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
ESC Draft Decision	0.00	0.00	0.00	0.00	0.00
Additional costs required for greenhouse gas offsets through purchasing certificates	0.45	0.47	0.49	0.51	1.92
Proposed YVW increase over Draft Decision	0.45	0.47	0.49	0.51	1.92

Labour cost increases

We welcome the Commission's acceptance of our expenditure proposals in relation to our labour costs – refer table 8 below. The expenditure proposals relate to increased costs for our defined benefit superannuation contributions as well as real increases in labour costs.

Table 8: Adjustments to labour cost forecasts proposed in Draft Decision (\$M Jan 2009 \$)

Element	2009/10	2010/11	2011/12	2012/13	Total
Labour costs	2.55	2.81	3.06	2.03	10.45

We note that the Commission will be reviewing labour cost increases between the draft and final decisions. We wish to draw to the Commission's attention to the fact that we are in the process of finalising our Enterprise Agreement for the next few years and that the planned real labour cost increases are consistent with recent public sector agreements and we are taking into account the productivity gains assumed by the Commission in our Enterprise Agreement.

Billing and collection costs

We note that the Commission has accepted the recommendation of the expenditure consultants on our expenditure proposals for billing and collection costs. The adjustments made by the Draft Decision to Yarra Valley Water's proposed billing and collection cost forecasts (as shown in table 4.8 of the Draft Decision) are set out in table 9.

Table 9: Adjustments to billing and collection cost forecasts proposed in Draft Decision (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Billing and collection	-0.91	-1.39	-1.64	-1.79	-5.73

As noted in our Water Plan and in our responses to the Commission's expenditure consultants draft report (provided in February 2009) and the Commission's expenditure review questions (provided in March 2009), the main elements of our billing and revenue collection operations are:

- agency debt collection
- bill payment costs
- merchant service fees
- bill printing and postage
- hardship support
- customer contact.

In the information submitted to the Commission and the expenditure consultant we presented forecasts of operating expenditure for each element of the billing and revenue collection function. In effect, the approach we adopted provides a detailed bottom-up assessment of the cost drivers for customer service and billing costs. In particular, our approach seeks to estimate the costs of each key activity in a manner consistent with the requirements set out in the guidance provided by the Commission (and noted on page 39 of the Draft Decision).

We consider that the approach we have applied provides the most appropriate method of forecasting customer service and billing costs.

In responding to the expenditure consultants' draft report in February of this year, Yarra Valley Water expressed concern regarding the approach adopted by the expenditure consultants. In particular, the consultants only conducted a very limited assessment of Yarra Valley Water's forecasting approach. As an alternative forecasting methodology, the expenditure consultants' draft report proposed an allowance for Yarra Valley Water's total customer service and billing operating expenditure by applying City West Water's proposed increase. This approach resulted in a significant reduction in the allowance for Yarra Valley Water's forecast expenditure requirements that could not be supported by any objective analysis of the costs that we are actually likely to incur.

In the expenditure consultants' final report, the consultants have again set aside Yarra Valley Water's detailed analysis of its billing and customer collection operating expenditure. Instead, rather than applying the unacceptably low benchmark based on the cost increases expected by City West Water, the consultants have proposed a benchmark based on the costs allowed for South East Water. In arguing that this benchmarking approach is appropriate, the consultants explain that Yarra Valley Water's per customer billing and collection expenditure should not vary significantly from those of South East Water due to their similar sizes and customer composition.

We remain strongly of the view that our detailed forecast of billing and customer collection operating expenditure should be reviewed on its merits. It is not appropriate to simply assert that Yarra Valley Water's costs should be same as another water utility's, unless a proper assessment of the underlying cost drivers has been performed for both water utilities. It is disappointing that the expenditure consultants' final report has not adopted this approach. Yarra Valley Water has therefore taken this opportunity to re-present its detailed estimates of the costs of billing and revenue collection, using the methodology and assumptions outlined in our detailed response to the expenditure consultants' draft report (of February 2009) updated to reflect the new (lower) total revenues and prices proposed under the Draft Decision.

In interpreting these updated cost estimates, it is important to recognise that the expenditure consultants and the Commission have applied a definition of the billing and revenue collection function that excludes hardship support and customer contact (The costs of these two activities were included in Yarra Valley Water's previous forecasts of billing and revenue collection costs.) Pages 57 and 58 of the expenditure consultants' expenditure final report on South East Water explain that the purpose of adopting this definition is to facilitate inter-company comparisons of the costs of billing and revenue collection. Our calculation of the updated cost forecasts, set out in table 10, therefore includes the costs of the following functions:

1. Merchant fees
2. Bill payment fees (customer arrangements)
3. Agency debt collection
4. Bill printing and postage

Table 10: Yarra Valley Water updated forecast of billing and revenue collection costs (\$ million January 2009)

Category	2007/08 Base	2008/09	2009/10	2010/11	2011/12	2012/13
Merchant service fees	0.724	0.027	0.130	0.124	0.102	0.135
Agency debt collection costs	0.812	0.331	0.302	0.318	0.268	0.308
Bill payment costs	2.490	0.268	0.265	0.235	0.160	0.102
Bill Printing & Postage	1.966	0.149	0.010	0.011	0.010	0.011

Additional costs above base		0.775	0.707	0.688	0.540	0.555
Cumulative additional costs		0.775	1.482	2.170	2.711	3.266
Updated total cost forecast	5.992	6.767	7.474	8.162	8.703	9.258
Cost per customer (\$)			11.71	12.62	13.29	13.95

Table 11 below shows the difference between Yarra Valley Water's updated estimate of the cost of billing and revenue collection, and the allowance proposed in the Draft Decision.

Table 11: Comparison of Yarra Valley Water forecast billing and revenue collection costs and Draft Decision allowance (\$ million January 2009)

	2009/10	2010/11	2011/12	2012/13
YVW updated cost forecast	7.474	8.162	8.703	9.258
Draft Decision allowance for YVW	6.670	7.040	7.420	7.830
Shortfall in Draft Decision allowance	0.804	1.122	1.283	1.428

The basis on which expenditure consultants determined Yarra Valley Water's allowance for billing and revenue collection costs is stated on page 61 of their report as follows:

"Given that the businesses operate in similar environments, we believe it is reasonable to expect that there should not be large variations in cost increases for the provision of fundamentally similar services.

Due to the similar size and customer make-up of Yarra Valley Water and South East Water, we consider that South East Water's increase in per customer operating expenditure for billing and collection services provides an appropriate benchmark for increases to Yarra Valley Water's operating costs."

We take the opportunity to reiterate our view that unless the Commission can be satisfied that it is comparing 'apples with apples', it is inappropriate to adopt simple high-level cost metrics for comparing functions.

Notwithstanding Yarra Valley Water's strong preference for a proper assessment of its expenditure forecasts, we also question whether expenditure consultants have properly applied a benchmark approach based on South East Water's cost per customer to determine Yarra Valley Water's allowance. As shown below, we believe that applying a cost per customer benchmark based on South East Water's allowed costs would produce an allowance for Yarra Valley Water that is very close to our detailed bottom-up estimate of costs.

Table 12 derives the billing and revenue collection cost allowance per customer for South East Water (using customer numbers set out in Volume II of the Draft Decision) and data set out in Table 6.20 of the expenditure consultants' final report on South East Water's expenditure.

Table 12: Derivation of “benchmark” cost per customer allowance for billing and revenue collection, based on SEW cost allowance (January 2009 prices)

South East Water	2009/10	2010/11	2011/12	2012/13
Draft Decision allowance (\$M)	7.21	7.81	8.42	9.14
Total SEW customer numbers	626,224	637,734	649,448	661,369
\$/customer	11.51	12.25	12.96	13.82

Applying this “benchmark” per customer cost allowance to Yarra Valley Water implies a total allowance for billing and revenue collection operating expenditure that is very similar to our bottom-up estimate of the total cost, as shown in table 13.

Table 13: Total cost allowance for Yarra Valley Water based on SEW cost per customer “benchmark” (January 2009 prices)

Yarra Valley Water	2009/10	2010/11	2011/12	2012/13
\$/customer (SEW "benchmark")	11.51	12.25	12.96	13.82
Total YVW customer numbers	638,000	646,600	655,000	663,600
Total YVW cost based on SEW "benchmark" (\$M)	7.35	7.92	8.49	9.17
YVW's estimate of total cost (\$M)	7.47	8.16	8.70	9.26
Difference between YVW's estimate and SEW "benchmark" (\$M)	0.13	0.24	0.21	0.09

The information and analysis set out above (and in Yarra Valley Water's water plan and further submissions in response to the expenditure consultants' draft report) strongly substantiate our estimate of the cost of billing and revenue collection for the water plan period. The correct application of South East Water's per customer billing and revenue collection cost allowance to Yarra Valley Water's customer numbers yields a total cost allowance that is very similar to our bottom-up cost estimate. This observation validates our own detailed cost estimate. Accordingly, the Commission should adopt our estimate of billing and revenue collection costs (as set out in table 14 below) for the purpose of its final decision.

Table 14: Yarra Valley Water's billing and revenue collection operating expenditure forecast (\$ million January 2009 \$)

	2009/10	2010/11	2011/12	2012/13	Total
YVW cost forecast	7.47	8.16	8.70	9.26	33.59
Draft Decision allowance	6.67	7.04	7.42	7.83	28.96
Increase required in Draft Decision allowance	0.80	1.12	1.28	1.43	4.63

Information Technology (IT) costs

We note the Commission has accepted the recommendation of the expenditure consultants on our expenditure proposals for our IT costs. Table 15 sets out the Draft Decision's adjustments to our Water Plan proposal⁶.

Table 15: Adjustments to IT cost forecasts proposed in Draft Decision (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
IT operating expenditure	-2.41	-2.36	-2.36	-2.36	-9.49

After our Water Plan was lodged we made adjustments to our Water Plan expenditure proposals. Table 16 sets out our adjusted IT operating expenditure forecast (submitted in February 2009) and the allowance proposed in the expenditure consultants' final report on which the Draft Decision relies.

Table 16: Yarra Valley Water IT operating expenditure (\$M Jan 2009 \$)

	2009/10	2010/11	2011/12	2012/13	Total
YVW Feb 2009 forecast	14.11	14.57	14.74	14.78	58.20
Draft Decision	12.86	13.37	13.53	13.58	53.34
Change proposed by Draft Decision	-1.25	-1.20	-1.21	-1.20	-4.86

The expenditure consultants' final report noted that the main drivers of our increased IT operating expenditure are:

- additional labour costs amounting to \$0.9 million in additional operating expenditure by the end of the period
- additional maintenance and external services costs in relation to the replacement of systems, resulting in \$2.38 million in additional operating expenditure by the end of the water plan period.

The expenditure consultants proposed reductions in our operating expenditure forecast in both of these areas. Our responses on the proposed reductions are detailed below.

Additional labour costs

In relation to Yarra Valley Water's additional labour costs, the expenditure consultants' final report found that the justification for additional staff was reasonable with the exception of the following items:

- \$0.15 million per annum from 2009/10 in relation to a 'Business Excellence Service' program

⁶ Refer page 53 of Draft Decision

- a provision for an additional \$0.25 million per annum for 2008/09 and beyond for the use of consultants and administrative support to supplement additional staff.

We welcome the expenditure consultants' findings that the justification for additional staff is reasonable, and we accept the consultants' view regarding the exclusion of the additional \$0.15 million per annum in relation to the 'Business Excellence Service' program.

In relation to the second item noted above, we consider that provision for additional expenditure for the use of consultants and administrative support to supplement internal resources should be made in the expenditure forecast. This provision is required because we have outsourced our IT facility, and therefore we must supplement our in-house resources with consultants (or otherwise pay our prime IT contractor) to undertake a variety of specialist tasks. This is cheaper in the long-run because we do not 'carry' unnecessary resources and we only use external expertise as required. In particular, supplementary resources will be required to deliver the following specific outputs and services over the Water Plan period:

- We intend to engage specialist consultants to develop a comprehensive business continuity plan and disaster recovery plan in 2009/10. This will ensure that a best-practice risk management plan exists.
- We also intend to revise and update our IT strategic plan in 2010/11, to ensure that the plan remains consistent with current best practice. The present IT strategic plan was developed in 2003. Specialist consultants will be required to assist in the revision and updating of the plan.
- A knowledge management strategy is to be developed in 2009/10, as a pre-cursor to our adoption of an electronic records and document management system (ERDMS) and other technologies. Specialist consultants are required to assist with this task.
- Supplementary resources are required to document and implement improved Information Technology Infrastructure processes, including Change and Release (in 2008/09), and Asset and Configuration Management (in 2009/10).
- We will undertake periodic benchmarking studies to examine the performance of our outsourced IT Facility providers in 2009/10 and 2011/12. These reviews are aimed at ensuring that the outsourcing partners are delivering value for money.
- Specialist consultants will be required to assist us in developing a strategic sourcing strategy (in 2010/11) and to produce a service level framework (in 2010/11) prior to Yarra Valley Water re-tendering its outsourced IT services and products.
- Specialist consultants will be required to undertake security health review including penetration testing and a SCADA Communications Security review (2011/12 and 2012/13)

The activities and outputs described above are required to support the delivery by us of our proposed service standards and other planned outcomes over the water plan period (so they are non-discretionary expenditure items), and they cannot be procured without the assistance of external consultants and contractors. We consider that our original forecast of the costs of procuring these deliverables (\$0.25 million per annum) is likely to be an under-estimate, rather than an over-estimate of the actual cost that will be incurred. We consider that the detailed information set out above provides a robust justification of the expenditure forecast (of \$0.25 million per annum) for supplementary resources, which was excluded from Yarra Valley Water's operating expenditure allowance in the expenditure consultants' final report and the Draft Decision. Accordingly, we request that the IT operating expenditure allowance should be increased by this amount.

Additional maintenance and external services costs

The expenditure consultants' final report (on pages 74 and 75) states:

"While we recognise that Yarra Valley Water is undertaking a number of capital investments in IT, and [we] are not able to determine which of Yarra Valley Water's proposed systems represent discretionary expenditure, it appears as though the costs relating to maintenance and external services for new systems are either overstated, the reductions in these costs for replaced systems are being understated, or both.

In particular, for maintenance and external services related to its new Customer Care and Billing (CC&B) system, Yarra Valley Water is forecasting an increase in operating expenditure of \$0.77 million in 2008/09 and \$0.9 million per annum thereafter, while reductions in costs amount to only \$0.05 million in 2009/10 and \$0.1 million per annum thereafter.

We would expect that efficiencies related to upgrading and replacing systems should go further towards reducing operating costs or provide benefits to customers. We note that Melbourne Water has proposed similar activities to Yarra Valley Water in terms of a capital management IT system enhancement and upgrade, and the phasing out of redundant systems. However, Melbourne Water has proposed significant reductions in operating costs as a result of these activities, and also through renegotiating contracts. Yarra Valley Water has not done so.

Therefore, in our revised forecast we have proposed not to include Yarra Valley Water's proposed additional operating expenditure in relation to its CC&B system, as we are not satisfied that the significant increase is justified. This results in a reduction of \$0.77 million in 2008/09, \$0.85 million in 2009/10 and \$0.80 million per annum thereafter."

The reasoning applied by the expenditure consultants' in determining to exclude the additional CC&B operating costs from Yarra Valley Water's IT operating expenditure forecasts does not reflect a proper consideration of the information provided by us in February 2009 in response to the expenditure consultants' draft report. For convenience, the salient points of the information provided in February 2009 are summarised below:

- The new CC&B system will replace the current IBIS billing system.
- Considerations relating to efficient risk management (rather than direct cost-savings) are the primary drivers of our decision to replace the existing system. For instance:
 - IBIS is almost 15 years old and it is written in an old language (called ABF) which is no longer taught. It uses the Ingress Database which has a relatively low penetration of the database market and this makes it difficult for us to find staff with the necessary skills to manage and maintain the existing system.
 - IBIS also represents a significant and unsustainable risk to us because it has been customised to such an extent that it can no longer be upgraded. We rely on the services of one contractor in order to make changes to the existing system including the necessary alterations for quarterly billing and price increases.

- We must retain IBIS for a minimum of two years after it is replaced (before decommissioning can be considered) in order to attend to customer queries. Yarra Valley Water is also legally required to retain the IBIS customer data and to provide the means to read that data for 7 years after the new system is commissioned. These requirements naturally limit the cost savings that can be achieved by replacing the IBIS system. For instance, the IBIS database software licence costs are presently \$115,000 per annum and IBIS Application licence costs are \$137,000 per annum. IBIS Database Licence costs are based on the number of users (forecast to be 10 after the new system commences service) and therefore the IBIS database costs are forecast to decline by 90% (to \$12,000 per year, providing an ultimate saving of \$0.1 million per year, as noted on page 74 of the expenditure consultants' final report). However, the IBIS Application licence fee is based on the number of properties and therefore will not be significantly reduced once the replacement CC&B system enters service.
- The costs to support and maintain the new CC&B system will be higher than the costs for the current IBIS system. For instance, in addition to the costs described above, the CC&B Application Software Maintenance and Licence costs are \$437,000 per year, facilities management costs are forecast to be an additional \$76,000 per annum and additional support costs for CC&B, the reporting environment, property information management and the satellite systems are forecast at a further \$288,000 per annum totalling \$802,000 per annum.

In effect, the tangible (or apparent) cost of the existing IBIS system is very low, however its contingent costs in terms of risk exposure are unsustainably high, and they justify the replacement of the existing system with one that entails higher tangible operating expenditure but prudent and efficient levels of risk exposure.

The information set out above demonstrates that it is inappropriate for the expenditure consultants' to compare the cost-savings that Melbourne Water expects to achieve through its IT system replacement program with the costs and benefits that we expect to achieve through the installation of our new CC&B system. Moreover, it is incorrect for the expenditure consultants to suggest that we have not proposed significant reductions in operating costs as a result of our IT system replacement and enhancement activities. These IT initiatives are leading to increases in direct IT operating expenditure requirements, however we expect to achieve significant efficiency savings across the entire business as a result of the implementation of the new CC&B system and related systems. This is acknowledged on page 44 of the efficiency consultants' final report.

As already noted, in determining to exclude the additional operating costs of the new CC&B system, expenditure consultants appear not to have had proper regard to the information set out in Yarra Valley Water's February 2009 response to the draft expenditure consultants' report.

Table 17 provides a summary of the total additional operating expenditure forecast for the COMPASS system, which is consistent with our February 2009 proposal.

Table 17: Revised operating expenditure for COMPASS system (\$ million January 2009)

	2009/10	2010/11	2011/12	2012/13	Total
YVW Feb 2009 forecast (Excluded from Draft Decision)	0.85	0.80	0.80	0.80	3.25

In addition to the explanatory information provided above, it is noted that our forecast of CC&B operating expenditure reflects the following practical considerations:

- It is normal that immediately after the introduction of new systems, there is a settling-in period as staff become familiar with the new capabilities of the system. Following this settling-in period, the business can then implement plans to capture further efficiencies over a number of years.
- New systems typically require a high level of application support costs to ensure that the systems deliver their planned benefits and outputs, and to ensure that bugs and defects present in the early versions of the systems are identified, managed and remediated. Over time as the systems stabilise, it is expected that support costs will reduce.
- COMPASS is a complex and critical system requiring 24 hours per day, 7 days per week application support to enable Yarra Valley Water to provide 24 x 7 customer service in the Customer Contact Centre.
- The operating expenditure forecast set out above excludes the costs of on-going training. These costs will be absorbed by us.

Conclusion: IT operating expenditure

On the basis of the information set out above, our revised IT operating expenditure forecast is summarised in Table 18.

Table 18: Yarra Valley Water's revised IT operating expenditure forecast (\$ million January 2009)

	2009/10	2010/11	2011/12	2012/13	Total
Draft Decision allowance	12.86	13.37	13.53	13.58	53.34
Add allowance for external consultants	0.25	0.25	0.25	0.25	1.00
Add additional CC&B operating costs	0.85	0.80	0.80	0.80	3.25
Revised IT operating expenditure forecast	13.96	14.42	14.58	14.63	57.59
Increase on Draft Decision allowance	1.10	1.05	1.05	1.05	4.25

The information set out in this response demonstrates that the level of IT operating expenditure proposed in the Draft Decision is insufficient. The delivery of our planned capital and operating expenditure programs, and the associated service quality and environmental outcomes is contingent upon us having a properly resourced and fully functional IT capability. The forecasts set out in the table above represent the IT operating expenditure required to support and deliver our IT capability, and are consistent with the Regulatory Principles set out in clauses 14(1)(a)(i) and (ii) of the WIRO. Accordingly, these forecasts should be adopted by the Commission for the purpose of its final decision.

Non prescribed versus prescribed expenditure

We note the Commission has accepted the recommendation of the expenditure consultants on our expenditure proposals regarding the reallocation of costs from prescribed to not prescribed services – refer table 19.

Table 19: Adjustments to not prescribed versus prescribed cost forecasts proposed in Draft Decision (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Reallocation from prescribed to non-prescribed	-1.55	-1.60	-1.65	-1.71	-6.51

In our response to the draft expenditure report in February 2009, we suggested that the continuation of the allocation of operating expenditure to non prescribed services as approved in the Commission's 2005 determination was appropriate. As there has been no increase in the level of service provided by Yarra Valley Water to Melbourne Water and Parks Victoria, we believe it is reasonable to assume that there has been no increase in the costs of providing such services, other than for growth in the volume of bills sent.

Acceptance of the expenditure consultants' recommendations would result in the cost of billing on behalf of Melbourne Water and Parks Victoria being \$4.45 million in 2009/10 and increasing to \$4.61 million in 2012/13. This represents 49% of our total billing and collection cost in 2009/10 and 37% in 2012/13, based on the billing costs on page 14 of this submission and the hardship and customer contact costs we supplied in our response to the expenditure consultants' draft report in February 2009. This is clearly an inappropriate proportion of costs to be allocated to the non prescribed service, because it does not reflect the level of resources consumed by Yarra Valley Water in providing these non prescribed services.

As an alternative, the allocation could be based on the number of times we bill for a non prescribed service compared with the total number of times we bill for our prescribed services. Currently we bill for these services as follows:

- 1 time per annum for Parks Victoria
- 4 times per annum for Melbourne Water
- 4 times per annum for water service charges
- 4 times per annum for water usage charges
- 4 times per annum for sewer service charges
- 4 times per annum for sewer disposal charges

Thus 5 out of 21 service billings each year relate to non prescribed services and thus a reasonable allocation would be 23.8% of our billing and collection costs plus specific costs (e.g. purchase of council property valuation data).

Table 20 shows the calculation of a reasonable cost allocation to billing on behalf of Melbourne Water and Parks Victoria

Table 20: Calculation of allocation of costs to billing on behalf of Melbourne Water and Parks Victoria (\$ million January 2009)

	2008/09	2009/10	2010/11	2011/12	2012/13
Billing and collection costs	6.77	7.47	8.16	8.70	9.26
Hardship support and customer contact	2.27	2.55	2.76	2.95	3.11
Non prescribed portion of costs (23.8% of billing and collection costs and hardship support and customer contact)	2.15	2.38	2.60	2.77	2.94
Purchase and loading of council valuations	0.60	0.60	0.60	0.60	0.60
Allocated cost of providing a billing service to Melbourne Water and Parks Victoria	2.75	2.98	3.20	3.37	3.54

Table 21 shows Yarra Valley Water's revised allocation of costs for providing a billing service to Melbourne Water and Parks Victoria.

Table 21: Revised allocation of costs for billing on behalf of Melbourne Water and Parks Victoria (\$ million January 2009)

Allocation of costs for providing a billing service to Melbourne Water and Parks Victoria	2008/09	2009/10	2010/11	2011/12	2012/13
Yarra Valley Water - Water Plan	2.90	2.90	2.90	2.90	2.90
Expenditure Audit & Draft Determination	2.90	4.45	4.50	4.55	4.61
Yarra Valley Water proposed	2.75	2.98	3.20	3.37	3.54
Increase on Draft Decision allowance	0.15	1.42	1.30	1.18	1.07

Note: Should the Commission not accept Yarra Valley Water's proposed increases to the Draft Decision allowance for billing and collection costs, then the costs apportioned to non-prescribed services should be adjusted proportionally, using the allocation ratio of 23.8% to total billing and collection costs to non-prescribed services.

Operations and maintenance costs

We note that the Commission has accepted the recommendation of the expenditure consultants on our expenditure proposals for our additional operations and maintenance costs. This results in a reduction of \$1.40 million in operating and maintenance costs over the regulatory period associated with two projects – Aurora regional water treatment plant and new pressure management assets. We accept the expenditure consultants' recommendations in relation to these two additional costs.

Minor items

We note that the Commission has accepted the recommendation of the expenditure consultants on our expenditure proposals for our other items of increased expenditure – refer table 22.

Table 22: Adjustments to other items of increased expenditure proposed in the Draft Decision by the Commission (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Trade waste reform - risk ranking of trade waste customers - HACCP22000 development and implementation - pricing impact assessment	-0.17	-1.02	-0.28	-0.21	-1.68
Australian biosolids membership	-0.01	-0.01	-0.01	0	-0.03
Metropolitan Sewerage Strategy	-0.21	-0.21	-0.05	0	-0.47
Water quality – improved communications	0	-0.05	-0.05	-0.05	-0.15
Research funding for Water Quality Research Australia	-0.16	-0.16	-0.16	-0.16	-0.64
Contribution to WSAA membership	-0.07	-0.07	-0.07	-0.07	-0.28
Tariff reform	0	-0.17	-0.17	0	-0.34
Financial reporting – valuing assets at fair value	0	-0.26	-0.26	-0.26	-0.78
Total	-0.88	-1.95	-1.04	-0.75	-4.62
Increase required in Draft Decision Allowance by YVW	0.17	1.02	0.28	0.21	1.68

The expenditure consultants' report states that the expenditure listed in table 23 either:

- did not represent new obligations; and/or
- could be undertaken using existing resources and in accordance with the usual 'swings and roundabouts' of a normal expenditure cycle; and /or

- represented non-operational expenditure that could be deferred, postponed or eliminated entirely given the current economic climate and proposed level of price increases⁷.

We are committed to undertaking the activities set out in table 23 and we believe the amounts shown above are legitimate additional business costs. We accept, however, the proposed reductions except those for trade waste and financial reporting. Further details are set out below.

Trade waste reform

An error was made in the translation of our figures for the 'Risk ranking of trade waste customers' expenditure item (see page 78 of the expenditure consultants' report). This matter has been discussed with the Commission's officers, and it has been agreed that an error was made. The correct figures are shown in Table 23. These corrected numbers are referred to in the discussion below.

Table 23: Corrections to risk ranking of trade waste customers operating expenditure (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Risk ranking of trade waste customers – Draft Decision	0	0.83	0.16	0.16	1.15
Risk ranking of trade waste customers – Water Plan (correct numbers)	0	0.083	0.016	0.016	0.115

We maintain that there are three items relating to trade waste in the period that will impose additional costs (\$0.645 million), over and above that which the business may be reasonably expected to absorb. These are as follows.

Table 24 shows the operating expenditure required for the first of these items (risk ranking of trade waste customers).

Table 24: Amounts for risk ranking of trade waste customers (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Risk ranking of trade waste customers	0	0.083	0.016	0.016	0.115

The introduction of risk ranking is intended to increase transparency in trade waste charging and achieve greater consistency of charging across the metropolitan area. It will relate more closely the costs of monitoring and control of high risk customers and the charges levied on such customers.

⁷ Ibid, p 78

Introducing risk ranking is not a desktop exercise. It requires an initial assessment of individual trade waste customers' circumstances to determine their risk rank. We will also make changes to our trade waste database to reflect the amended form of the customer data. We will incur costs to inform customers and explain the modified charge.

Risk ranking is a dynamic process because the volume and composition of a customer's effluent can change over time making it higher or lower risk. We will need to keep track of this which will impose additional, ongoing administrative cost.

Table 25 shows the operating expenditure required for the second trade waste item (HACCP22000 development and implementation).

Table 25: Amounts for HACCP22000 development and implementation (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
HACCP22000 development and implementation	0.05	0.05	0.05	0.05	0.20

HACCP22000 accreditation is critical to enable us to demonstrate to customers (and Melbourne Water) that we have rigorous processes and controls in place to ensure that the recycled water we provide is not hazardous due to the trade waste entering the sewerage system. Maintaining accreditation requires annual certification and continuous improvement. Certification involves an annual audit and other fees totalling around \$25,000 per year. We have also identified target improvements for the period. Examples include enhanced sewer headspace monitoring and management and pollution prevention plans at customer sites posing high risk. We anticipate that we will spend a further \$25,000 per year on such projects.

Table 26 shows the operating expenditure required for the third trade waste item (pricing impact assessment).

Table 26: Amounts for trade waste pricing impact assessment (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
Trade waste pricing impact assessment	0.12	0.14	0.07	0	0.33

Melbourne Water proposes to change two of its bulk load parameters in 2009/10:

- Total nitrogen to total Kjeldahl nitrogen, and
- Total dissolved solids to inorganic total dissolved solids.

The change to the nitrogen charge should have a marginal impact on customers. The inorganic solids charge, however, is doubling and this may have a significant impact on some customers. We intend to absorb this increase in 2009/10 because we are not in a position to implement the new charge. Before we change our charge to reflect Melbourne Water's bulk charge we must identify the relevant customers and the potential impact on them. We expect that some customers will need assistance to mitigate substantial bill increases.

Financial reporting – valuing of assets at fair value

We acknowledge the expenditure consultants' observation that an alternative approach to meeting AASB 1049 Accounting Standard would be to undertake a cash flow analysis approach rather than a costly asset revaluation⁸. We will therefore seek from the Commission a pass through of additional costs if we are required to undertake a revaluation of assets to meet this accounting standard during the regulatory period.

Productivity and efficiency

We note that the Commission's draft decision implies a 1.5% per annum efficiency improvement to be achieved through the following productivity increases:

- 1% per annum productivity gains
- Shared services savings of \$7 million over 4 years
- Implied savings due to "swings and roundabouts" as detailed above

In relation to shared services efficiency gains, while we accept that our share of potential gains is \$2 million per annum we do not agree with the expenditure consultants' interpretation of the timing of the gains from this process. Further information on this matter is presented below.

In our Water Plan, we identified \$4.0 million of net savings associated with shared services as shown in Table 27. We believe that the profile of shared services savings, net of implementation costs, remains the best estimate for the regulatory period.

Table 27: Shared services costs (net) in our Water Plan (\$ million January 2009)

Element	2009/10	2010/11	2011/12	2012/13	Total
YVW Water Plan Proposal					
Identified shared services savings	0.50	1.00	1.50	2.00	5.00
Identified implementation costs	0.50	0.50	0	0	1.0
Net savings	0	0.50	1.50	2.00	4.00
ESC Draft Decision					

⁸ Ibid p 79

Element	2009/10	2010/11	2011/12	2012/13	Total
Shared service and bulk procurement savings to be achieved by YVW	1.00	2.00	2.00	2.00	7.00
Increase required in Draft Decision Allowance by YVW	0.50	1.00	0.50	0	2.00

To fully explain our response regarding the level of shared services savings proposed in the Draft Decision, we need to briefly recap the history.

The review of the metropolitan retail water sector by the Victorian Competition and Efficiency Commission (VCEC) identified that \$8 to \$10 million per annum could be achieved through shared services and bulk procurement of materials⁹. Specifically, Recommendation 4.1 of the VCEC review stated:

“That the Victorian Government retain the three metropolitan retailer structure and require the metropolitan water sector (including Melbourne Water) to develop and implement shared services and bulk procurement of materials. The Government should amend the water businesses’ statement of obligations to establish a target level of future annual savings to be achieved of at least \$8 to \$10 million per annum and ensure that this is incorporated in their corporate plans.”¹⁰

VCEC reasoned that:

“the Commission considers that the combined operating and capital costs savings (at least \$8 million per annum over two years and up to \$10 million per annum over three to five years) can be achieved by a combination of more use of shared services, coordinated procurement and open book benchmarking. Moreover, the increased use of benchmarking of costs by the retailers offers the opportunity to deliver additional savings in operating and capital costs. These figures exclude any savings arising from Melbourne Water’s participation in this process. Given the significance of its bulk charges to the retailers’ cost base, it is important that Melbourne Water participates in further investigation of opportunities.”¹¹

Importantly, VCEC identified that these savings would be achieved though a combination of operating and capital expenditure inputs and that they would take time to achieve. In their work plan for implementation of recommendation 4.1, VCEC suggested that a timeframe of 6 to 12 months should be provided for the implementation of this recommendation¹². This does not say that the planned savings would be achieved within that time but that the Government would amend the Statements of Obligations to specify the achievement of this target level of savings. The VCEC report indicates that these savings would be achieved by the end of regulatory period.

⁹ Victorian Competition and Efficiency Commission, 2008, *Water Ways: Inquiry into Reform of the Metropolitan Retail Water Sector: Final Report*, February, p 82

¹⁰ Ibid

¹¹ Ibid

¹² Ibid, p xxxv

The Government's response to this recommendation was:

"The Government notes that the estimated future savings of at least \$8 to \$10 million per annum from shared services and coordinated procurement of common inputs are small in comparison with the aggregate revenues of the businesses, nevertheless they will be used as a guide to assist the businesses in pursuing a material level of savings over the forthcoming regulatory period.

The Government will amend the Statements of Obligations to require the metropolitan water sector (including Melbourne Water) to examine opportunities for shared services and co-ordinated procurement of common inputs, and implement such arrangements where it is assessed that they will yield material net savings in business costs. The Government expects these arrangements to be incorporated into the businesses' corporate plans."¹³

The Statement of Obligations has not yet been formally amended by the Government. Following on from the Government's response (noted above), we understand that the amendment will only require an examination of opportunities for shared service cost reductions.

Given the above discussion, we believe that the expenditure consultants' view that "VCEC recommended that the annual savings be achieved within 6-12 months after receiving Government support"¹⁴ is inconsistent with VCEC recommendation and the Government's response. We believe, therefore, that the expenditure consultants have misinterpreted the timelines for achieving the shared services savings and that the Commission should therefore not rely upon the consultants' advice.

Uncollected revenue

The Draft Decision noted that Yarra Valley Water has included its 'Arrange and Save' expenditure in operating expenditure forecasts. On this basis, the Draft Decision determined that Yarra Valley Water should not be given a significantly higher provision for uncollected revenue.

The Draft Decision is based on an incomplete understanding of our uncollected revenue forecast. In particular, the only credits charged to operating expenditure are those given to hardship customers under the 'Arrange and Save' program when a customer makes five consecutive payments on time and in full. When a customer makes on-time and in-full payments continually for six months, their greater than 180 day debt is written off. When they make on-time and in-full payments continually for nine months their greater than 89 day debt is written off. These debt write-offs are included in our uncollected revenue forecasts.

The Commission has adopted the approach applied by South East Water to estimate uncollected revenue and, for all businesses, has simply increased the amount by 14.8% per annum. In our case, the level of uncollected revenue suggested by the Commission is approximately equal to that expected due to the general increase in customer numbers and the increase in bill value (i.e. the same proportional number of customers default on payment of a higher value bill). Thus there is no allowance for the expected increase in the number of customers who enter the 'Arrange and Save' program or default on payment due to the higher bills.

¹³ Victorian Government, 2008, *Victorian Government Response to: Victorian Competition and efficiency Commission's final Report, Water Ways: Inquiry into Reform of the Metropolitan Retail Water Sector*. July, p 7

¹⁴ Halcrow Pacific p/l and Deloitte touché Tohmatsu, 2009, *Yarra valley water expenditure Review*, march, p 28.

Table 28 sets out our re-calculation of uncollected revenue based on the Commission's Draft Determination price increases. It also shows the allowance proposed in the Draft Decision.

Table 28: Calculation of uncollected revenue (\$ million January 2009)

	2008/09	2009-10	2010-11	2011-12	2012-13
Base level of uncollected revenue (2007/08 actual amount)	2.06	2.06	2.06	2.06	2.06
Increase due to general increase in customer numbers (1.3% pa)	0.03	0.06	0.09	0.11	0.14
Increase due to increase in value of bill (Draft Determination price increases)	0.31	0.70	1.03	1.41	1.84
Sub Total (Base Increase)	2.40	2.82	3.18	3.58	4.04
Increase due to increased number of customers defaulting on payment because of higher bills	0.42	0.74	1.21	1.41	1.61
Total forecast uncollected revenue	2.82	3.56	4.39	4.99	5.65
ESC Draft Decision	2.36	2.71	3.11	3.57	4.11
Increase required in Draft Decision Allowance by YVW	0.46	0.85	1.28	1.42	1.54

Table 28 shows that the allowance for uncollected revenue is significantly below the allowance required by Yarra Valley Water. We therefore suggest that for the purpose of the Final Decision, the Commission should adopt the total forecast uncollected revenue amount shown above.

Capital expenditure

Overview

Following the submission of our Water Plan in early November 2008, we re-prioritised our capital program for the period from 2008/09 to 2012/13. This was largely in response to our deteriorating 2008/09 financial position caused by reduced water sales from the drought combined with increased costs associated with the Target 155 water conservation program. The expenditure consultants report noted:

“The revised annual budget incorporates the deferral of a total of \$59.2 million (made up of \$73 million in deferrals and \$13.8 million in new expenditure) from 2008/09 to the next regulatory period. In addition, Yarra Valley Water has deferred a further \$55.7 million from the next regulatory period into the future regulatory period commencing 1 July 2013.”¹⁵

We note that the Commission has fully accepted our re-prioritised capital program.

¹⁵ Ibid, p 84

Financing capital investments - WACC

Introduction

The Commission's Draft Decision proposes the adoption of a real "vanilla" Weighted Average Cost of Capital (WACC) of 4.8%.

As shown in Table 29, the Draft Decision proposes the application of the same parameter values as those applied in the June 2008 Decision, with the exception of two values: the real risk free rate and the debt margin.

Table 29: WACC parameters applied in the April 2009 Draft Decision and the earlier (June 2008) decision

Parameter	June 2008 Decision	April 2009 Draft Decision
Real risk free rate	3.23%	1.51% - 1.76%
Equity beta	0.65	0.65
Market Risk Premium	6%	6%
Debt Margin	1.75%	2.0% - 2.7%
Capital structure	60%	60%
Franking credit value	0.5	0.5
Real WACC feasible range	Not stated	4.3% - 4.9%
Real WACC adopted	5.8%	4.8%

Page 77 of the Draft Decision notes:

"The reduction in the WACC to 4.8 per cent (from the 5.8 per cent proposed by the businesses in their Water Plans) is primarily driven by the lower real risk-free rate, which has been partly offset by an increase in the debt margin."

This section sets out our response to the WACC proposed in the Draft Decision. We consider that certain aspects of the Draft Decision should be re-considered by the Commission, in order to ensure that the prices finally approved by the Commission will meet the requirements of clauses 14(1)(a)(i), (iv) and (v) of the Water Industry Regulatory Order. In particular, it is noted that:

- The Draft Decision adopts a "feasible range" for the real risk free rate that is between 44 and 68 basis points lower than the directly observable real yield on indexed bonds. This decision adversely affects the benchmark cost of equity. We estimate that increasing the real risk free rate by 44 basis points would lead to an increase in the allowance for the cost of equity of approximately \$4.5 million per annum.

- The Draft Decision adopts a Market Risk Premium of 6%, which is lower than the value of 6.5% adopted by the Australian Energy Regulator (AER) in its 1 May 2009 determination of WACC parameters to apply to electricity network businesses. Yarra Valley Water estimates that increasing the Market Risk Premium to 6.5% would lead to an increase in the allowance for the cost of equity of approximately \$2.6 million per annum.

Our detailed responses on these key issues are set out under separate headings below.

Real risk free rate

Page 78 of the Draft Decision explains the Commission's approach as follows:

"In the 2008 water price review, the Commission calculated the real risk-free rate by using the average yield over a 40 day trading period on nominal Commonwealth Government Securities with a ten year term to maturity as a proxy for the nominal risk-free rate. An independent forecast of inflation was then used to convert this into a real risk-free rate according to the Fisher equation.

In 2008, this approach resulted in a real risk-free rate of 3.23 per cent based on a nominal risk-free rate of 6.227 per cent and an inflation forecast of 2.9 per cent. These assumptions were also adopted by the metropolitan businesses in their Water Plans.

This approach to calculating the real risk-free rate was also used by the Commission during the Gas Access Arrangement Review (GAAR) in 2007, although a 20 day trading period was used to calculate the average nominal yield on Commonwealth Government Securities. The Commission had previously used the yield on inflation-indexed Commonwealth Government Securities as a direct proxy for the real risk-free rate. However, the Commission adopted the present approach when issues relating to absolute and relative bias with the inflation-indexed bonds were identified during the GAAR." (Emphasis added)

Page 79 notes that:

"For this draft decision, the Commission has calculated the nominal risk-free rate based on the average yield on nominal Commonwealth Government Securities over the 40 day trading period to 31 March 2009, which has resulted in a rate of 4.299 per cent."

For the purpose of deriving an implied real risk free rate from the observed nominal bond yields, the Commission adopted a CPI forecast in the range of 2.5% to 2.75%. Page 80 of the Draft Decision notes that:

"The assumptions about the nominal risk-free rate and inflation result in a feasible range for the real risk-free rate of between 1.508 per cent and 1.755 per cent. The Commission notes that this range reflects current financial market conditions. The range will be updated for the final decision."

Yarra Valley Water considers that the Commission has not in fact derived an estimate of the real risk free rate that reflects current financial market conditions.

Table 30 shows the real and nominal yields on 10 year Government bonds averaged over 40 trading days to 30 June 2008, and 40 trading days to 31 March 2009. The differences between the yields now prevailing, and those prevailing at the time of the Commission's 2008 Decision are also shown.

Table 30: Nominal and real risk free rates and bond yields in June 2008 and March 2009

	30 June 2008: (June 2008 Decision)	31 March 2009: (Draft Decision)	Change since June 2008
Nominal yield (on 10 year bonds)	6.48%	4.299%	-2.18%
ESC's lower bound for the real risk free rate	3.23%	1.508%	-1.72%
ESC's upper bound for the real risk free rate	3.23%	1.755%	-1.48%
Real yield on indexed 10 year bonds (interpolated from bonds maturing in August 2015 and August 2020)	2.49%	2.19%	-0.30%

The above table shows that the Draft Decision is imposing a reduction in the real risk free rate of between 1.48% and 1.72%, compared to the reduction in the observed yield on indexed bonds of only 0.3% over the period from June 2008 to the present.

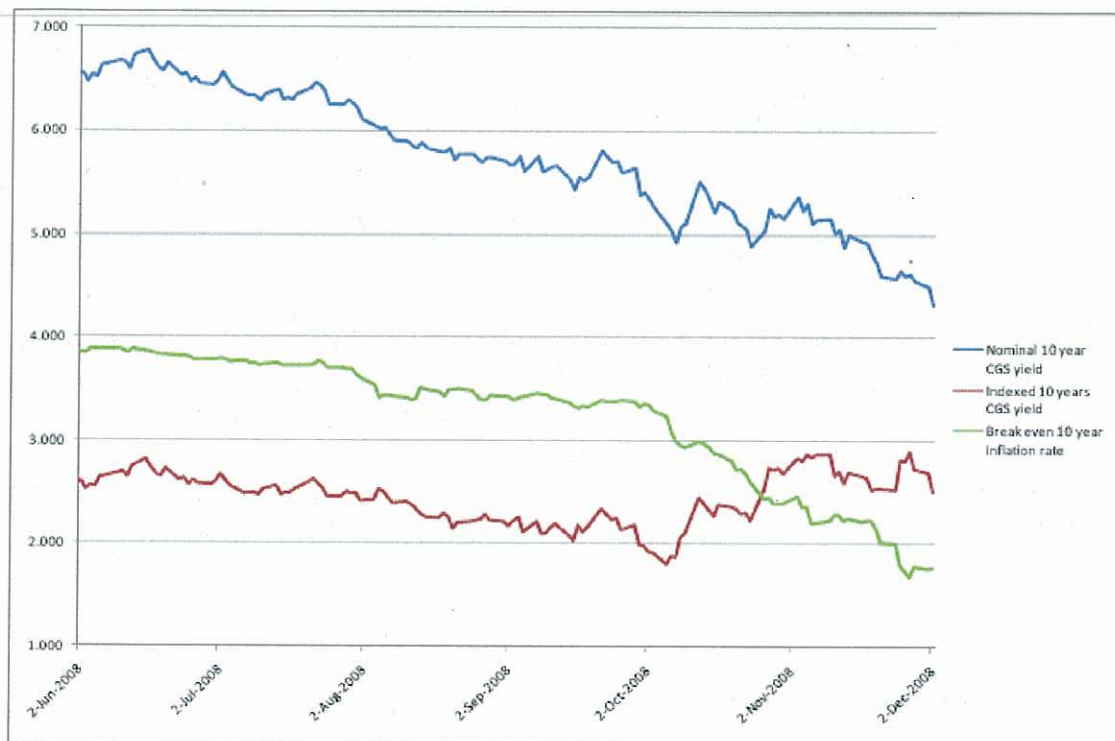
Table 31 shows the difference between the observed real yield on indexed bonds, and the upper and lower bounds of the “feasible range” of the real risk free rate proposed in the Draft Decision.

Table 31: Shortfall in real risk free rate proposed in the Draft Decision

	Lower bound of real risk free rate “feasible range”	Upper bound of real risk free rate “feasible range”
Draft Decision proposal	1.508%	1.755%
Real yield on indexed bonds	2.19%	2.19%
Shortfall in proposed real risk free rate compared to observed real yields	0.68%	0.44%

Table 32 shows the Commission’s range for the risk free rate implies a shortfall of between 0.44% and 0.68% compared to the directly observed 10-year yield on indexed bonds (of 2.19%). We estimate that increasing the real risk free rate by 0.44% would lead to an increase in Yarra Valley Water’s revenue allowance in relation to the cost of equity of approximately \$4.5 million per annum over the five year regulatory period.

It is noted that at the time of the June 2008 Final Decision, the “bias” referred to by the Commission in the passage from page 78 of the Draft Decision (cited above) led to the real risk free rate implied from nominal bonds (3.23%) being higher than the observed indexed bond yield (2.49%). The global financial crisis appears to have led to a reversal of this bias, as shown in the tables above and Figure 1.

Figure 1: 10 year yields

Source: Transend Networks Pty Ltd, *Transmission Revised Revenue Proposal: Regulatory Control Period commencing 1 July 2009*, January 2009, page 48

These recent developments have led electricity network companies to propose to the AER that the real risk free rate applied in the calculation of the regulatory WACC should be no less than the directly observable real yield on indexed bonds.

On 1 May 2009 (after the publication of the Commission's Draft Decision) the AER issued its Final Decision on WACC parameters for electricity networks. The AER's Final Decision addressed the matters raised regarding the derivation of a real risk free rate proxy from nominal bond yields and inflation forecasts as follows:

"The AER notes the views from CEG and the NSW Treasury regarding the decrease between nominal and indexed CGS yields, in the context of the RBA's inflation forecasts. On this point the AER notes that it has previously determined that the yields on indexed CGS are not a reliable estimate given supply concerns in that market. The indexed CGS market is characterised by illiquidity, which has been acknowledged by the RBA in previous advice to the ACCC. The RBA stated that:

The issue of insufficient supply is relevant for the indexed bond market. Turnover in the bonds is low and the market is fairly illiquid. (Letter from RBA Financial Market Group to Mr Joe Dimasi ACCC re: distortions in CGS yields, 9 August 2007, p.3)

There has been no evidence presented to suggest that the supply situation in indexed CGS markets has changed such that these yields can now be considered reliable."

We consider that the AER's assessment of this particular issue supports the application of a real risk free rate that is at least equal to the observed yield on indexed bonds. In particular:

- Prior to the onset of the global financial crisis, the issue of insufficient supply in the indexed bond market had previously led regulators - including the Commission - to adopt real risk free rates that were higher than observed indexed bond yields. In effect, the limited supply of indexed instruments pushed their yield down, and on this basis the yields on indexed bonds were regarded as being too low to provide a valid proxy for the real risk free rate.
- The AER notes that no evidence has been presented to suggest that the supply situation in indexed CGS markets has changed so that these yields might now be considered reliable. In effect, the AER is saying that yields on indexed bonds remain too low to provide a valid proxy for the real risk free rate.

In view of the information set out above, we suggest that it would be reasonable for Commission to review its Draft Decision to ensure that the real risk free rate applied in the WACC calculation is a reasonable proxy for that parameter. In particular, we suggest the effective real risk free rate should be at least equal to the observed yield on indexed bonds. In fact, on the basis of the AER's discussion noted above, the effective real risk free rate should be higher than the observed yield on indexed bonds. Given the material financial impact on the water companies, it is essential that the Commission examines this issue in further detail in its Final Decision.

Equity market risk premium

Page 81 of the Draft Decision explains the basis of the Commission's proposal to adopt a value of 6% for the market risk premium (MRP) as follows:

"A market risk premium of 6.0 per cent is generally considered to be consistent with observable market returns. Further, it is consistent with the Commission's previous pricing decisions in water and energy and is the benchmark generally adopted by other Australian regulators, including the AER in its [draft decision on its] recent review of WACC parameters."

As already noted, on 1 May 2009 the AER published its Final Decision on its review of WACC parameters for electricity networks¹⁶. The Final Decision adopted a value of 6.5% for the MRP.

Page 238 of the Draft Decision explains the reasons for the increase in the MRP value as follows:

"The AER considers that prior to the onset of the global financial crisis, an estimate of 6 per cent was the best estimate of a forward looking long term MRP, and accordingly, under relatively stable market conditions—assuming no structural break has occurred in the market—this would remain the AER's view as to the best estimate of the forward looking long term MRP."

However, relatively stable market conditions do not currently exist and taking into account the uncertainty surrounding the global economic crisis, the AER considers two possible scenarios may explain current market conditions:

- *that the prevailing medium term MRP is above the long term MRP, but will return to the long term MRP over time, or*
- *that there has been a structural break in the MRP and the forward looking long term MRP (and consequently also the prevailing) MRP is above the long term MRP that previously prevailed.*

¹⁶ AER, *Final decision: Review of the weighted average cost of capital (WACC) parameters - Electricity transmission and distribution network service providers*, May 2009.

Whilst it cannot be known which of these scenarios explain current financial conditions, both are possible, and both suggest a MRP above 6 per cent at this time may be reasonable. However, having regard to the desirability of regulatory certainty and stability, the AER does not consider that the weight of evidence suggests a MRP significantly above 6 per cent should be set.

Accordingly, the AER considers that a MRP of 6.5 per cent is reasonable, at this time, and is an estimate of a forward looking long term MRP commensurate with the conditions in the market for funds that are likely to prevail at the time of the reset determinations to which this review applies.

Based on the weight of evidence, the AER considers there is persuasive evidence to depart from the previously adopted MRP of 6 per cent.”

It is noted that the AER's WACC Final Decision applies to 5-year regulatory determinations that are to be made over the next 5 years, so the MRP value of 6.5% will be in force for a period of up to 10 years from the present.

It is also noted that the AER's Final Decision was published after the Commission released its Draft Decision. The reasoning and analysis set out in the AER's Final Decision regarding the MRP value now supersedes that contained in the Commission's Draft Decision. We therefore suggests that for the purpose of the Final Decision, the Commission should adopt an MRP value of 6.5%, noting this would be consistent with the latest detailed reasoning provided by the Australian Energy Regulator on this matter. We estimate that increasing the MRP to 6.5% would lead to an increase in the allowance for the cost of equity of approximately \$2.6 million per annum.

Financing capital investments – other matters

Introduction

Our response to the Draft Decision's proposals on funding for deferral of regulatory depreciation is outlined below.

Deferral of regulatory depreciation

The Commission has rejected our proposal to defer regulatory depreciation on existing assets for 2008/09 citing as a reason its view that regulatory depreciation incurred in 2008/09 should be included in the roll forward of the regulatory asset base (RAB) value for 2009/10.

We agree that in normal circumstances regulatory depreciation is one of the building blocks that makes up the revenue requirement, and where the forecast revenue includes a provision for the recovery of sunk investment (in the form a regulatory depreciation charge), then the regulatory depreciation charge should be deducted from the RAB value in the roll-forward calculation.

In 2008/09, the price increase was set at 14.8%. This was less than the price increase required to ensure that our forecast revenue would equal the revenue requirement. Thus we believe the 2008/09 price increase did not provide the business with the efficient costs of supplying regulated services and a commercial return on assets as required by Regulatory Principles contained in the WIRO (in that it did not provide for the depreciation of assets).

In the template the Commission provided to Yarra Valley Water with the Draft Decision, the revenue requirement for 2008/09 is \$464.5 million. However the forecast revenue is only \$409.5 million. Deferral of \$48.8 million of depreciation on existing assets for 2008/09 would result in the 2008/09 revenue requirement being reduced to \$416.9 million which is much better aligned to the forecast revenue. Further, we believe it could be reasonably argued that the regulatory depreciation of assets constructed during 2008/09, \$1.6 million, should also be deferred, reducing the 2008/09 revenue requirement to \$415.4 million, and leaving a shortfall between the 2008/09 revenue requirement (\$415.4 million) and the forecast revenue (\$409.5 million) of \$5.9 million. This revenue shortfall will be borne by us.

It is noted that the impact of deferring the depreciation is an increase in our revenue requirement of \$2.4 million per annum between 2009/10 to 2012/13.

We request that the Commission give careful consideration to our suggestion that the opening RAB value for 2009/10 be calculated on the basis that the 2008/09 revenue allowance for Yarra Valley Water did not contain a regulatory depreciation provision, and therefore the regulatory depreciation for that particular year was deferred. We note that the Regulatory Principles set out in clause 14.1 of the WIRO should guide the Commission's consideration of this matter.

We agree with the Draft Decision that the deferral of regulatory depreciation for 2009/10 to 2012/13 is no longer required to achieve our commitment that bills no more than double over the period.

Demand forecasts

Per capita usage assumptions for 2009/10 under Target 155 (T155) campaign

Our proposed demand forecast for 2009/10 was made on the assumption of 150 litres per person per day¹⁷. The Commission rejected our forecast, raising residential demand volumes by 3.9 GL for 2009/10. We concur with the Commission's view that the underlying per capita assumption adopted should represent a reasonable sharing of risk between business and customers (Draft Decision pp 99, 103). Yarra Valley Water, however, maintains that customers are tracking towards consumption lower than 155 litres per person per day during 2009/10.

Our financial year-to-date average consumption up to the most recent reporting week¹⁸ has been 155 litres per person per day. Our customers are heeding the call to save water and are investing in changes to support water savings. As storages are expected to remain low, we expect aggressive conservation programs to continue with messages to reduce consumption up to end 2009/10 and we expect our customers will continue to respond with water savings accordingly.

A construction of likely per person consumption over the 2009/10 year is compelling for the 150 litres per person per day case. Two scenarios are outlined below – “high end” scenario and “most likely” scenario.

“High end” scenario:

This scenario provides a high usage/low savings consumption picture for 2009/10 under Stage 3a water restrictions with T155. As the T155 Campaign commenced in December 2008, per person consumption recorded for July through November 2008 were effectively pre-T155. The following adjustments were made to derive a high usage consumption profile for 2009/10 under T155:

- Per person consumption for July through November 2009 were forecast based on current year usage adjusted for savings observed in May 2009, using this as a proxy for minimum savings achievable¹⁹. Comparing May 2008 (under Stage 3a) and May 2009 (Stage 3a+T155), we observe a reduction of about 8 litres per person per day. This reduction, when applied to consumption in July through to November, would represent a conservative estimate of savings from changes made by customers inside the home.
- Per person consumption for December 2009 through to April 2010 were retained at levels observed during 2008/09 under Stage 3a+T155 water restrictions. This assumption ignores both potential savings from further short term behavioural changes under T155 and ongoing reductions attributable to improved appliance stock efficiency, for example, from showerhead exchanges, replacement of clothes washers, retirement of old single flush toilets and Five Star Homes regulations.

¹⁷ Not 149 l/p/d noted in Commission's Draft Decision, Vol I, p 97

¹⁸ The most recent T155 reporting week was 8am Thursday 14 May 2009.

¹⁹ Note that consumption to-date shows that we can expect May 2009 consumption to be below that experienced under 3a in May 2008 (147 l/c/d). The May month-to-date average for Yarra Valley Water currently sits at 139 litres per person per day.

- Per person consumption for June 2010 were retained at 2007/08 levels under Stage 3a. Again, this provides a conservative “high end” forecast and ignores both savings from short term behavioural changes under Target 155 and ongoing reductions attributable to improved appliance stock efficiency.

Applying (and in spite of) these conservative adjustments, we forecast a “high end” average consumption of 150 litres per person per day for 2009/10.

Table 32: “High end” scenario

Litres per person per day	YVW 2007/08 3a	YVW 2008/09 3/3a+T155	High
			YVW 2009/10 3a+T155
July	147	141	133 (f)
August	150	143	135 (f)
September	160	152	144 (f)
October	174	167	159 (f)
November	173	158	150 (f)
December	175	145	145 (f)
January	181	185	185 (f)
February	173	186	186 (f)
March	187	151	151 (f)
April	164	139	139 (f)
May	147	139 (f)	139 (f)
June	139	139 (f)	139 (f)
Financial Year Average	164	154	150

Consumption subject to the Target 155 Campaign are shaded yellow.

Arrows denote 3a forecasts used.

(f) Denotes forecast

“Most Likely” scenario:

To provide a more representative/balanced scenario of likely consumption patterns during 2009/10, the following adjustments were made:

- Per person consumption for July through November 2009 and June 2010 were estimated based on the average actual percentage reduction observed recently from December 2008 through to April 2009 under T155 of 8.5%. This is representative of the additional reductions customers have demonstrated they can make under a T155 environment and conservatively includes the two high consumption months of January and February 2009 when unusually extreme hot weather reduced the ability of customers to save water.
- Per capita consumption for December 2009 through to May 2010 were retained at 2008/09 levels, that is, consistent with the “high end” scenario and effectively assuming no further savings from improved appliance stock efficiency and further short term behavioural changes under T155.

These assumptions yield a per person average of 147 litres per person per day for 2009/10. The following table provides a comparison of consumption profiles under both scenarios:

Table 33: "Most likely" scenario

Litres per person per day	YVW 2007/08 3a	YVW 2008/09 3/3a+T155	High	Low
			YVW 2009/10 3a+T155	YVW 2009/10 3a+T155
July	147	141	133 (f)	129 (f)
August	150	143	135 (f)	131 (f)
September	160	152	144 (f)	139 (f)
October	174	167	159 (f)	152 (f)
November	173	158	150 (f)	144 (f)
December	175	145	145 (f)	145 (f)
January	181	185	185 (f)	185 (f)
February	173	186	186 (f)	186 (f)
March	187	151	151 (f)	151 (f)
April	164	139	139 (f)	139 (f)
May	147	139 (f)	139 (f)	139 (f)
June	139	139 (f)	139 (f)	131 (f)
Financial Year Average	164	154	150	147

 Consumption subject to the Target 155 Campaign are shaded yellow.

Arrows denote 3a forecasts used.

(f) Denotes forecast

The two scenarios demonstrate that a consumption range of 147 and 150 litres per person per day is possible for Yarra Valley Water for 2009/10, with 150 litres per person per day in the higher usage case and 147 litres per person per day representing a more likely picture. An assumption of 150 litres per person per day for 2009/10 would be an appropriate outcome.

Restrictions assumption for non-residential customers

The Draft Decision suggests that we did not apply restrictions assumptions to non-residential customers. We have applied restrictions assumptions to relevant segments of non-residential customers. Demand by our non-residential customers was analysed and forecast by five major segments:

- Top 42 (Our share of Melbourne's Top 200),
- Non-residential customers with greater than 10 ML usage,
- Councils,
- Schools, and
- all remaining non-residential customers.

It is our expectation that savings in the Top 42 and the high end of the “>10ML” customers will be limited due to savings already expected/achieved under the WaterMAP program. Usage by the Council segment has been adjusted to reflect restrictions. In addition, expected savings from Support 155 initiatives (the non-residential program for T155) have been built in for the lower end of the “>10ML” customers and all other non-residential customers.

Watering/non-watering day impact on consumption

We agree that rainfall and temperature are indeed drivers of consumption. Another key driver of usage is whether consumption is occurring on a day that is a designated ‘watering’ day under Stage 3a restrictions rules. Given similar temperatures and rainfall, consumption is higher on a watering day compared to a non-watering day.

Block Shares

The Commission has rejected our allocation of demand across the residential tariff blocks. We have carried out further analysis since our most recent submission. We undertook regression analysis on billed block shares against consumption to gain a better understanding of how block 2 and block 3 shares are changing at different levels of household consumption. Given total household consumption (not per capita consumption) drives usage in blocks 2 and 3, this regression provides a sound basis for estimating how savings should be allocated between blocks.

The resulting regression is statistically significant and we have utilised the results to estimate block 2 and block 3 shares based on expected average household consumption for each year of the regulatory period. The block shares calculated from the regression are provided in Table 34 for comparison against Commission-defined values.

Table 34: Amended block shares

	07/08 Act	2009/10		2010/11		2011/12		2012/13		05/06 Act
	3a	3a+T155		2		2		1		PWSR
Block	YVW	YVW regression	ESC	YVW regression	ESC	YVW regression	ESC	YVW regression	ESC	YVW
1	73.2%	78.8%	76.5%	77.1%	73.7%	76.5%	73.7%	76.1%	72.8%	64%
2	19.8%	17.8%	18.5%	18.5%	19.4%	18.7%	19.4%	18.9%	20%	24%
3	7.0%	3.4%	5%	4.4%	6.9%	4.8%	6.9%	5.0%	7.3%	12%

The block 3 share for 2009/10 has been increased materially from our February submission based on regression outcomes, with the corresponding decrease in block 1. We note that with the exception of 2009/10, the regression proposes lower block 3 shares across the regulatory period compared to our February submission. Proposed block 3 shares are also lower than those defined by the Commission in its Draft Decision. We also note that block 2 shares submitted for the regulatory period were validated by the regression.

We propose the adoption of these revised block shares as more representative of how savings from restrictions and T155 will be realised across our residential customer base.

Resulting block share volumes are shown in table 35.

Table 35: Block share volumes

Block	2009/10 ML	2010/11 ML	2011/12 ML	2012/13 ML
1	70,093	73,111	74,752	76,304
2	15,833	17,543	18,273	18,951
3	3,024	4,172	4,690	5,013

Bulk water and sewerage

Cost allocation

In its review, VCEC recommended a methodology for allocating Melbourne Water's costs under which all sunk costs would be allocated between the retailers according to 2004-05 volumes and future costs would be allocated according to forecast demands.

We are concerned about the allocation of Melbourne Water's costs to the extent that cost allocation methods or assumptions may drive unwarranted differences in the bulk charges levied on the three retailers. We do not, and we have never had, access to the Melbourne Water cost allocation model. We assumed that, in accordance with statements made in the issues paper (of December 2008), the Commission would review Melbourne Water's allocation of costs between the retailers. For this reason, we saw no need to raise issues relating to Melbourne Water's cost allocation in our earlier submissions.

In relation to this matter, the Commission has pointed out that the revenue recovered from each retailer does not change materially over the regulatory period. However, this is not an indication that the allocation of costs is in accordance with the VCEC recommendation. As noted above, this issue has a bearing on the level of bulk charges paid by the three retailers, and it contributes to any differences between the end prices charged by the three retailers. It is therefore a matter that warrants careful consideration.

We encourage the Commission to review the cost allocation model to ensure its compliance with the VCEC recommendation before the Final Decision is handed down.

Profile of price increase

Yarra Valley Water agrees with the Commission's proposal to adjust bulk prices for retailers in 2009/10 so that the revenue collected by Melbourne Water from each retailer better reflects the cost allocation. However we support Melbourne Water's approach for a smoothed price increase from 2010/11 to 2012/13 rather than the Commission's proposal for a price path that closely matches expected revenue to the revenue requirement in each year. As bulk charges will make up 43% to 55% of our revenue requirement over the regulatory period, a smoothed bulk charges price path should minimise large fluctuations in our accounting profits.

Retail water and sewerage services

Introduction

In its Draft Decision, the Commission stated that it was not satisfied with our Water Plan proposal to maintain the current tariff for residential customers so that there are no unnecessary bill impacts for customers at a time of high price rises. The Draft Decision suggests that this approach would mean that prices do not adequately reflect costs and so not send the correct signals to customers.

The Commission suggests that water usage charges should increase at a faster rate than the sewage disposal charge (SDC). This will lead to water charges making up a greater part of the bill and sewerage charges a smaller part. A greater part of the tariff will be based on variable charges so giving the customer more control over their bill.

In light of these comments, we have revised our tariff proposal to accord with the Draft Decision. Details of our revised proposal are set out below.

Revised proposal – residential charges

We agree with the Commission's view that customers should receive a price signal that conveys the value of the service used. We intend to apply the price increase to conform to the requirements of the Draft Decision. This can be achieved by applying our Water Plan price path to water usage and smaller increases to SDC and water and sewerage fixed charges. (The Water Plan price path is shown in table 38.) Table 39 shows the resulting prices obtained using this approach.

Table 38: Price paths

Element	2009/10	2010/11	2011/12	2012/13
Water Plan	19.0%	17.0%	11.0%	10.0%

Table 39: Indicative Prices (\$ January 2009)

	Fixed (\$ per year)		Variable (\$/ kL)			
	Water	Sewerage	Step 1	Step 2	Step 3	SDC
2008/09	75.54	184.54	1.02	1.20	1.77	1.32
2009/10	87.63	214.07	1.21	1.42	2.10	1.46
2010/11	97.53	238.26	1.42	1.66	2.46	1.62
2011/12	107.78	263.29	1.58	1.85	2.73	1.78
2012/13	119.10	290.96	1.73	2.03	3.00	1.96
Percentage increase from 2009/10 to 2012/13	57.7%	57.7%	70.0%	70.0%	70.0%	48.5%

The impact these charges will have on the typical customer using 165 kilolitres per year is shown in table 40.

Table 40: Bill impacts (\$ January 2009)

	2008/09	2009/10	2010/11	2011/12	2012/13
YVW revised proposal	585	703	793	867	947

Our proposal meets the expectation that no customer will see their bills more than double over period from 2008/09 to 2012/13.

We are pleased that the Commission proposes to approve our proposed amendment to seasonal sewerage discharge indices to reflect the level of water restrictions in a given year.

Strata offices

For the purpose of clarity, we are proposing the Commission to add the following part (c) to clause 3.2 Service charges only to be imposed on connected properties:

“(c) Each habitable property within a subdivision with an owner’s corporation shall be deemed connected if under 3.2(a) and 3.2(b) the common property is determined to be liable for water and sewerage service charges.”

The word 'habitable' is meant to preclude strata car-parks or storage areas. The new clause will have no practical impact on residential properties because they will have satisfied the existing criteria for connected anyway; otherwise they would not have a council occupancy certificate.

Non residential charges

The Commission did not raise any issues with our proposed charges for non-residential customers. We will therefore charge on the basis of the Water Plan.

Recycled water

Introduction

Yarra Valley Water is pleased the Commission proposes to approve a continuation of the 2008/09 pricing principles for recycled water services provided to large non residential and unique customers. We are also pleased that the Commission proposes to approve scheduled charges for third pipe recycled water services.

However, we are concerned that for developments completed during the regulatory period, development-specific prices for recycled water services are required to be set which may result in different prices for different developments for the same product. The Draft Decision states:

“For developments completed during the regulatory period, pricing principles should be applied to determine the prices charged for recycled water provided in these new developments. These prices should be then added to the tariff schedule and become subject to the annual price approval process.”²⁰

We currently have scheduled tariffs for class 'A' recycled water supplied via third pipes and we propose that scheduled charges for third pipe recycled water services be common across our licensed area, in a similar manner to water and sewerage charges.

Pricing Strategy

We note the Commission's requirement that the businesses develop a pricing strategy for recycled water to be implemented when water restrictions are eased. We propose to do so as part of the overall tariff review to be carried out during the regulatory period.

Sewage Discharge Factors

In our Water Plan, we proposed to have different seasonal indices to be used for calculating the volume of sewage discharged for each restriction level. This is to reflect that as restriction levels are increased and there is less outdoor use of water, a larger proportion of water supplied to a property is discharged to sewer.

Customers with third pipe recycled water can use the recycled water for gardens, lawns and outdoor use during any level of water restrictions. Thus customers with recycled water will have similar total water usage (recycled water plus potable water) as an unrestricted potable water only customer.

For recycled water customers we propose to apply the current seasonal indices that are also applied to potable water only customers. These indices will apply to the total water usage (that is, recycled water plus potable water) of recycled water customers. Table 41 below sets out the relevant indices.

²⁰ Metropolitan Melbourne Water Price Review 2009 Draft Decision volume I, Essential Services Commission, p143

Table 41: Proposed seasonal indices for calculating the sewage disposal charge

	JAN	FEB	MAR	APR	MAY	JUN	JUL	AUG	SEP	OCT	NOV	DEC
Current Indices & Recycled Water Customers	1.7	1.7	1.5	1.2	1.1	1.0	1.0	1.0	1.1	1.2	1.4	1.5
PWSR	1.575	1.575	1.425	1.175	1.075	1.0	1.0	1.0	1.075	1.175	1.325	1.425
Stage 1 Restrictions	1.45	1.45	1.35	1.15	1.05	1.0	1.0	1.0	1.05	1.15	1.25	1.35
Stage 2 Restrictions	1.325	1.325	1.275	1.125	1.025	1.0	1.0	1.0	1.025	1.125	1.175	1.275
Stage 3a Restrictions	1.2	1.2	1.2	1.1	1.0	1.0	1.0	1.0	1.0	1.1	1.1	1.2
Stage 4 Restrictions	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0

Trade waste

Trade waste charges

We are pleased that Commission recognises the difficulty associated with changing our total dissolved solids (TDS) charge to an inorganic TDS charge. We will carry out the necessary work over the coming year that will allow us to introduce the amended charge.

We plan to phase in an inorganic TDS charge from 1 July 2010 with the full impact of Melbourne Water's inorganic TDS being reflected in trade waste charges in 2012/13. Our timetable for introduction of this charge is set out in table 42.

Table 42: Timetable for introduction of inorganic total dissolved solids charges

	Activity
November 2009	Interim proposals to Commission for comment
December 2009	Draft proposal for stakeholder input
March 2010	Final proposal to Commission
May 2010	Commission consultation on proposal
June 2010	Commission approval of inorganic TDS prices for 2010/11

We will also carry out a review of trade waste charges in cooperation with Melbourne Water and the other metropolitan utilities.

Other services

New Customer Contributions (NCCs)

We welcome an extension of the existing arrangements for NCCs and we believe that a consistent State-wide approach will give developers certainty and comfort that the principles behind the charges do not constantly change.

We also welcome the additional pricing principles for calculating non scheduled new customer contributions in sewerage backlog areas. These principles give recognition to the businesses' established backlog programs where timeframes are clearly defined and they provide a fairer outcome for customers.



Yarra Valley Water | *a fresh approach*

General Enquiries:

Web: www.yvw.com.au Email: enquiry@yvw.com.au

General Enquiries Telephone: **13 1721** Emergencies and Faults: **13 WATER (13 92837)** TIS: **13 1450**